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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

Iran's Balance-of-Payments Prospects Look Up

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
February 1972

INTELLIGENCE MEMORANDUM

IRAN'S BALANCE-OF-PAYMENTS PROSPECTS LOOK UP

Summary

1. On 14 February 1971, Iran and other Persian Gulf members of the Organization of Petroleum Exporting Countries (OPEC) won an agreement from the private oil companies to pay substantially larger revenues through 1975. The agreement came at a time when Iran's foreign reserves had fallen dangerously low and when the balance of payments was under severe pressure because of heavy imports and costly debt repayments associated with the Shah's military and economic development programs. While these programs had greatly enlarged Iran's military capabilities and sparked an impressive 10% average annual growth of the economy, this continued expansion was threatened by inadequate foreign exchange receipts.

2. Largely as an outgrowth of the February agreement, however, Iran's balance-of-payments outlook has brightened considerably. Oil revenues -- some 80% of export earnings -- probably will triple during fiscal years 1971-75[1] in comparison with those of the previous five years. With these and other export earnings -- plus expected foreign loans -- Iran should be able simultaneously to continue its 10% growth rate, to expand its military establishment, and generally to increase its foreign reserves.

Discussion

Balance-of-Payments Trends

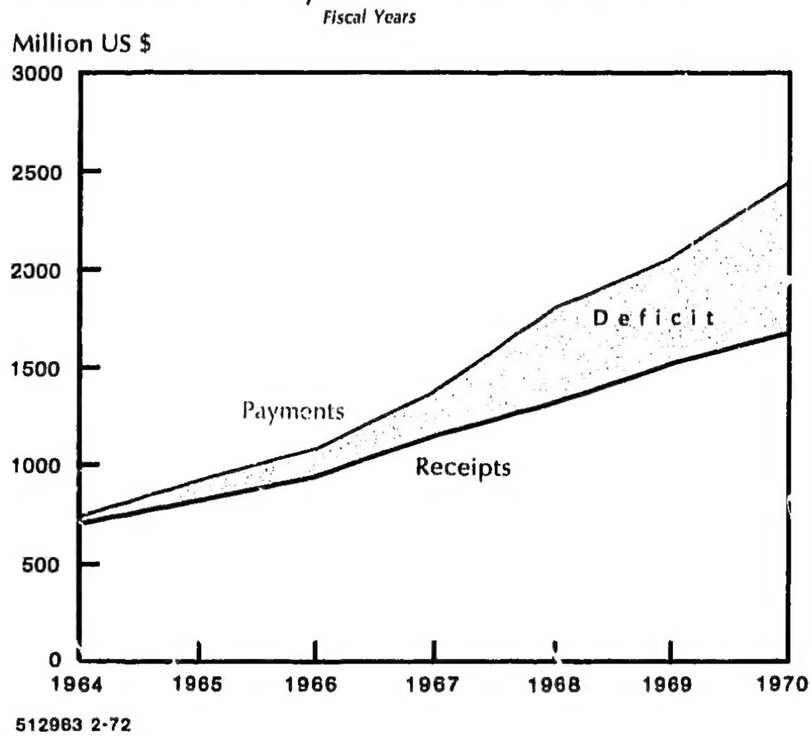
3. Since the mid-1960s, Iran has incurred generally increasing current account deficits. Although receipts rose from some $700 million in FY

1. The Iranian fiscal year (FY) begins on or about 21 March of the year stated, in conformity with the vernal equinox.

Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.

1964 to $1.7 billion in FY 1970, imports increased even faster and the current account deficit mounted from $45 million to $762 million (see the chart and Table 1). Since foreign reserves were not large to begin with, these deficits were covered mainly by long-term foreign borrowing.

Iran: Balance-of-Payments Current Account



Import and Export Developments

4. Imports grew rapidly as a result of the Shah's forced-draft programs of economic and military development. Dissatisfied with the economy's 4% growth rate during the early 1960s, the Shah sharply increased public investment and encouraged private investment. In response, government investment nearly quadrupled between FY 1964 and FY 1969, reaching an estimated $1.1 billion, while private investment almost doubled, to about $1 billion. Investment rose from 15% to 23% of gross national product (GNP) in only five years, and real economic growth increased to an average of about 10% annually.

Table 1

Iran: Balance of Payments

Million US $

	FY 1964	FY 1965	FY 1966	FY 1967	FY 1968	FY 1969	FY 1970
Current account							
Receipts	714	817	986	1,175	1,325	1,519	1,692
Oil sector (net receipts) a/	568	608	761	857	958	1,099	1,268
Other goods exports, services, and transfers	146	209	225	318	367	420	424
Payments	759	932	1,090	1,388	1,805	2,072	2,454
Imports	643	791	952	1,205	1,527	1,723	2,069
Private sector	542	574	677	756	868	967	1,037
Public sector	101	217	275	449	659	756	1,032
Of which:							
"Other government agencies" (probably largely defense and defense-related goods)	74	140	171	216	296	355	504
Services and transfers b/	116	141	138	183	278	349	385
Balance	-45	-115	-104	-213	-480	-553	-762
Capital account	140	60	84	308	401	594	741
Long-term loans and credits	28	80	147	257	475	671	806
Short-term loans	0	36	0	94	17	83	146
Loan repayments (principal)	-73	-61	-77	-55	-103	-178	-249
Private investment (net)	185 c/	5 c/	14	12	12	18	38
Errors and omissions	0	3	-4	-5	-4	0	0
Surplus or deficit	+95	-52	-24	+90	-83	+41	-21
Changes in foreign assets (- indicates increase in assets)	-95	+52	+24	-90	+83	-41	+21
Monetary gold	Negl.	9	-14	-21	7	-1	27
Foreign exchange	-113	60	38	-86	76	-40	-46
IMF account	18	-17	0	17	0	0	40

a. Equals government receipts from oil companies plus foreign exchange received from the sale of domestic currency to oil companies.
b. Including small purchases of non-monetary gold.
c. The oil companies made special one-time payments of $185 million in FY 1964 and $5 million in FY 1965 for concessions granted in 1965.

5. Because of the country's limited production capabilities, imports increased an average of 21% annually. About one-third of economic development spending went for imports in FYs 1968-70. Defense and defense-related imports (which are believed to make up much or all of the balance-of-payments item "other government agencies") accounted for an even larger share of defense spending. Arms imports alone have amounted to about 30% of defense spending in recent years, while other defense and defense-related imports (construction materials, equipment, and supplies for military bases, factories, and other military installations) possibly increased the share to 50%. As a result, public sector imports increased ninefold, while private sector imports doubled. By FY 1970, the public sector accounted for about half of total imports, contrasted with less than one-sixth in FY 1964.

6. Imports of machinery, component parts, and raw materials have increased in line with Iran's rapid industrial growth, much of which has taken the form of simple processing and assembly-type operations. The import content of final products is more than 80% for such industries as motor vehicles, tires, pharmaceuticals, and synthetic fibers, and it is also fairly high in some other industries. Much of the industrial expansion had the aim of import-substitution in the consumer goods field. The value of finished consumer goods imports remained relatively constant, and its share of estimated non-defense imports declined from about 23% in FY 1964 to roughly 10% in FY 1970. However, when account is taken of the import content of locally produced consumer goods it seems clear that total consumer-related imports have increased.

7. Export earnings grew by an average of 16% yearly from FY 1964 to FY 1970 -- an impressive expansion, although decidedly slower than for imports. Oil export revenues[2] increased from $479 million to $1,148 million – mainly because of a 15% average annual rise in volume (see Table 2) – but oil's share of total exports dropped slightly. The rapid growth of Iran's oil exports – almost double the rate for other Middle Eastern countries -- reflects both the increased output that Tehran persuaded the producers' consortium to undertake and the greatly expanded market for Iranian oil, notably in Japan. Meanwhile Iran's non-oil exports also grew at a brisk rate. Although exports still are dominated by three traditional product categories – carpets, cotton, and fruits and nuts – there have been growing sales of industrial goods such as vehicles, tires, footwear, chemicals, textiles, knitwear, and soap. Most of these products have gone to the USSR and other bilateral trading partners where quality and price are not the major considerations.

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2. Throughout this memorandum, only net values are given for oil export earnings. These net earnings are equated with the government's share of total oil export revenues.

Table 2

Iran: Oil Exports

Fiscal Year	Average Volume a/ (Thousand Barrels per Day)	Value of Oil Exports b/ (Million US $)	Oil Exports as a Share of Total Exports (Percent)
1964	1,589	479	84
1965	1,764	514	80
1966	1,997	653	81
1967	2,446	752	79
1968	2,674	854	80
1969	3,230	955	80
1970	3,614	1,148	81

a. Crude oil and refined products. Except for 1969 and 1970, the data are for calendar years.
b. Equals government's share of total oil export earnings.

Capital Inflows and Foreign Reserves

8. To finance its rapidly growing current account deficits, Iran relied mainly on foreign loans. Credit drawdowns mounted from a scant $28 million in FY 1964 to $952 million in FY 1970, when they equaled 56% of current account receipts. Repayment obligations consequently increased sharply. Debt servicing payments rose from 9% of current account receipts in FY 1966 to 20% in FY 1970, when principal and interest totaled $346 million. Although net foreign private investment has increased in recent years, it was only 5% of the net capital inflow in FY 1970.

9. Despite growing recourse to foreign credits, Iran's foreign reserves have been under periodic pressure since the mid-1960s, at times equaling as little as one month's imports. Even greater borrowing abroad – or a disastrous drop in reserves – was avoided only by obtaining special

payments from the oil companies in the mid-1960s and again in recent years. In the first case, the companies made special payments of nearly $200 million for concessions granted in 1965, and in FY 1969 and FY 1970 they were prevailed on to make advance payments (in effect, forced short-term loans) of some $100 million. Immediately prior to the February 1971 oil settlement, reserves were only $222 million – the equivalent of slightly over one month's imports.

The February 1971 and January 1972 Oil Settlements

10. The outlook for Iran's foreign exchange earnings improved considerably in early 1971, when the private oil producers agreed to make substantially larger payments to Iran and other Persian Gulf members of OPEC. The terms of the 14 February agreement were largely an outgrowth of Tehran's forceful role in the negotiations. As it applied to Iran, the agreement affirmed the tax-rate increase on net income (from 50% to 55%) that had been agreed to temporarily in November 1970, provided an immediate increase of 21% (or 38 cents per barrel) in the posted price on which taxes are based, and stipulated regular increases in the posted price during 1971-75 to offset worldwide inflation. The inflation adjustment provided for increases of 2.5% annually plus an additional 5 cents per barrel effective 1 June 1971 and on the first of the year in 1973 through 1975. In all, the February 1971 agreement called for Iran's revenue per barrel of exported oil to increase by an average of 9.5% yearly, from 87 cents in FY 1970 to $1.37 in FY 1975. Because the volume of oil exports was expected to double, oil export earnings during the period were expected to increase from $1.1 billion to $3.6 billion.

11. Prospective oil revenues during the next several years were boosted another 8.5% by the 20 January 1972 agreement that Persian Gulf members of OPEC negotiated with the oil companies.(3) The countries demanded a revenue adjustment to offset the higher costs of imports caused by the recent changes in world currency values. Because its oil revenues are computed in US dollars and paid in sterling at the official exchange rate, Iran faced increased costs for imports from countries that revalued their currencies against the dollar – notably Japan and most West European nations. For Iran's imports, the weighted average increase in cost is estimated to be 8%. The devaluation adjustment of 20 January further raises Iran's expected average revenue per barrel and total oil earnings during the several years to the levels shown in Table 3. Total oil revenues during FYs 1971-75 will amount to an estimated $14 billion – triple those of the preceding five years.

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Table 3

Iran: Projected Oil Exports a/

Fiscal Year	Average Revenue per Barrel (US $)	Average Volume (Thousand Barrels per Day)	Value of Exports b/ (Million US $)
1970	0.87	3,614	1,148
1971	1.21	4,518	1,995
1972	1.31	4,737	2,265
1973	1.38	5,425	2,732
1974	1.44	6,211	3,264
1975	1.49	7,112	3,868

a. Crude oil and refined products.
b. Equals government's share of total oil export earnings.

Balance of Payments in FY 1971

12. A decided improvement in Iran's balance of payments is occurring in the current fiscal year, largely because of the sharply increased oil earnings. The oil sector is expected to contribute about $2.2 billion – including returns from sales of local currency to oil companies – to current account receipts in FY 1971 (see Table 4). This is approximately $900 million more than last year and $200 million more than Iran initially anticipated from the February 1971 agreement. The additional $200 million reflects mainly a fortuitous decline in shipping costs, brought on by a surplus of charter oil carriers. This cost reduction made Persian Gulf oil cheaper than that produced in the Mediterranean area and resulted in greater-than-expected gains in Iranian oil exports. Iran, moreover, is getting an additional $24 million this fiscal year from increased port dues on oil carriers and from other provisions that the Shah exacted from the oil companies in July 1971.

Table 4

Iran: Balance-of-Payments Projections

Million US $

	FY 1971	FY 1972	FY 1973	FY 1974	FY 1975
Current account					
Receipts	2,670	3,015	3,600	4,245	4,985
Oil sector (net receipts) a/	2,170	2,440	2,930	3,475	4,100
Other exports and services	500	575	670	770	885
Payments	3,000	3,610	3,975	4,395	4,840
Non-defense imports b/	1,895	2,280	2,585	2,930	3,300
Other imports (largely defense and defense-related items)	620	750	750	750	750
Services c/	485	580	640	715	790
Balance	-330	-595	-375	-150	+145
Capital account	475	440	400	350	305
Credit drawdowns	750	750	750	750	750
Repayments (principal) d/	-315	-360	-410	-470	-525
Private investment (net)	40	50	60	70	80
Surplus or deficit	+145	-155	+25	+200	+450

a. Equals government receipts from oil companies plus foreign exchange received from the sale of domestic currency to oil companies.
b. Projected to increase in accordance with an assumed 10% annual growth in gross national product.
c. Non-factor services estimated at 14% of imports. Interest on debt is estimated on the basis of projections by the World Bank.
d. Estimate, based on projections by the World Bank.

13. In addition to the estimated $2.2 billion from the oil sector, Iran is expected to earn about $300 million in FY 1971 from non-oil exports, compared with $261 million the previous year. During the first five months, non-oil exports were running at an annual level of about $274 million, exclusive of gas shipments which should amount to at least $30 million. Freight, insurance, and other service earnings probably will provide about $200 million. Total current account receipts, therefore, will probably amount to about $2.7 billion.

14. Iran's current account payments in FY 1971 are estimated to be $3.0 billion. This assumes a 19% rise in non-defense imports (which Iran's recent experience suggests would attend a 10% gain in real GNP) plus a small upward adjustment to reflect the impact during the last part of the year of the international currency adjustments. Imports of defense-related commodities and other items are estimated at some $600 million – up from $500 million in FY 1970 – on the basis of the defense budget. Service payments are projected at $485 million, about $100 million more than in FY 1970.

15. If the foregoing projections are realized, Iran will have a current account deficit in FY 1971 of $330 million – less than in any year since FY 1967. The World Bank has estimated credit drawdowns of about $750 million and repayments of about $315 million, which – with expected net private investment of $40 million – indicates net capital receipts of $475 million. Although the net capital inflow thus is expected to be well below the FY 1970 level of about $740 million, Tehran has a good chance of covering the current account deficit and raising reserves substantially. This conclusion is supported by the upward trend of reserves through December 1971.

Outlook through FY 1975

16. Projection of Iran's balance of payments through FY 1975 suggests that the country's foreign exchange position will probably improve even though very rapid import growth is in prospect. We estimate that Iran's net receipts from the oil sector will increase by about 90% between FY 1971 and FY 1975. Non-oil exports should continue to grow by at least 15% yearly, and earnings from services can be expected to expand at about the same rate. Total current account receipts accordingly are projected to rise from $2.7 billion in FY 1971 to about $5.0 billion in FY 1975 – an average annual gain of 17%.

17. Current account payments during the period are expected to increase by an average of about 13% yearly. It is assumed that imports of non-defense items will bear the same relationship as in the past to GNP, which is projected to expand about 10% yearly as planned. The estimated

imports have been adjusted by the average weighted percentage increase in cost of 8% resulting from currency revisions by Iran's trading partners. The increase in costs during FYs 1971-75, estimated at nearly $1 billion, essentially washes out the projected gains in oil revenue resulting from the January 1972 agreement.

18. Although some increase in defense imports is anticipated in FY 1972, it is assumed that they subsequently will level off and probably not exceed about $750 million annually. This assumption does not appear unwarranted, given the already large military buildup and the further enlargement and upgrading of the arms inventory that could be accomplished at this projected import level. Although Iran appears concerned over the high cost of defense(4) and has called for more balance in defense and development spending, our assumption regarding defense imports could be vitiated by policy changes or by military hostilities involving Iran.

19. Should current account receipts and payments rise as projected, Iran would gradually eliminate its deficit and have a surplus in FY 1975. Credit drawdowns are estimated at $750 million annually – the upper level of a $700-$750 million range cited by the World Bank as attainable on reasonable credit terms. Debt repayments (principal and interest) consistent with such drawdowns and existing debt are expected to rise gradually and by FY 1975 should approximate the credit inflows. The net inflow of private investment is expected to continue to increase by roughly $10 million annually, reaching $80 million in FY 1975. Although net capital inflows are expected to decline somewhat, the amount probably will remain substantial. These receipts, coupled with gradual improvements in the current account balance, should enable Iran to have a surplus in its balance of payments and increasing foreign exchange holdings in FY 1973 through FY 1975.

4. Defense obviously has held back economic development efforts in the past. If allowed to grow at recent rates, it could absorb at least a quarter of Iran's GNP by 1975.